

# The United States in the Global Economy

The United States is linked to the global economy in many ways. As you will learn in the first section of Chapter 5, there are four types of **economic flows** among nations: trade; resource; information and technology; and financial.

The second section explains why **international trade is important** to the United States. In *relative* terms, other nations have exports and imports that are a larger percentage of their GDPs because they often have a small domestic market and a limited resource base. By contrast, the exports and imports of the United States account for a smaller percentage of its GDP because it has a larger domestic market and a more abundant resource base. In *absolute* terms, however, the United States is the world's largest trading nation. Most of the trade is with Canada, Mexico, the European Union, Japan, China, and OPEC countries. This volume of trade has grown over the years with expansion of the global economy and the emergence of new trading nations.

In the third section, you learn about the principle of **comparative advantage**, which is the basis for all trade between individuals, regions, and nations. A nation, for example, will specialize in the production of a product for which it has a lower domestic opportunity cost and trade to obtain those products for which its domestic opportunity cost is higher. Thus, specialization and trade increase productivity within a nation and increase a nation's output and standard of living.

Trading in a global economy requires a **foreign exchange market** in which national currencies are exchanged, as you discover in the fourth section. When the U.S. dollar price of another currency has increased, the value of the U.S. dollar has *depreciated* relative to the other currency. Conversely, when the U.S. dollar price of another currency has decreased, the value of the U.S. dollar has *appreciated* in value relative to the other currency.

**Government** can affect international trade in many ways, as you learn in the fifth section. Governments can impose protective tariffs, import quotas, and nontariff barriers, or they can foster exports through subsidies. The reasons for the interventions are difficult to explain given the strong economic rationale for free trade based on the principle of comparative advantage. Nevertheless, public misunderstanding of the gains from trade, or political considerations designed to protect domestic industries, often lead to government policies that create trade barriers and distort the free flow of products between nations, thus increasing costs for society.

The sixth section discusses **multilateral agreements** among nations and the creation of **free-trade zones** that

have been designed to reduce trade barriers and increase world trade. In the United States, the process of gradual tariff reduction began with the Reciprocal Trade Agreements Act of 1934. Since 1947, worldwide multilateral negotiations to reduce trade barriers have been conducted through the General Agreement on Tariffs and Trade (GATT). The Uruguay Round of GATT negotiations established the World Trade Organization (WTO) as GATT's successor. Trade negotiations under the WTO continue in the Doha Round that began in 2001.

The other major development has been the formation of free-trade zones. The European Union (EU), which was originally started in 1958 as the Common Market, is now a trading bloc of 27 European nations. A major accomplishment of the EU, in addition to the reduction of trade barriers among member nations, was the establishment of a common currency (the **euro**) that is used by 15 nations. The United States, Canada, and Mexico also established a free-trade zone in 1993 through the North American Free Trade Agreement (NAFTA).

As you will learn in the next-to-last section of the chapter, international trade can impose adverse effects on domestic workers and industries. One measure passed by the U.S. Congress to help workers displaced by international trade is the Trade Assistance Act. Although the offshoring of domestic jobs creates difficulties for some workers, there also can be benefits from it for the economy and domestic businesses and workers.

The final section of the chapter briefly explores the issue of the effects of **increased competition in the global economy**. Global competition has certainly changed production practices and employment in U.S. industry. Many U.S. firms have adapted to the changes by increasing productivity to reduce costs, improving product quality, and expanding export markets. Although some firms have failed and domestic jobs have been lost, the benefits of free trade to the economy in the form of lower prices, greater economic efficiency, and a wider variety of products far outweigh any losses.

## ■ CHECKLIST

When you have studied this chapter you should be able to

- ☐ Identify the four main categories of economic flows linking nations.
- ☐ Explain the importance of international trade to the U.S. economy in terms of volume, dependence, trade patterns, and financial linkages.

- ☐ Describe several factors that have facilitated the rapid growth of international trade since World War II.
- ☐ Identify the key participating nations in international trade.
- ☐ Explain the basic principle of comparative advantage based on an individual example.
- ☐ Compute the comparative costs of production from production possibilities data when you are given an example with cost data for two countries.
- ☐ Determine which of two countries has a comparative advantage in an example.
- ☐ Indicate the range in which the terms of trade will be found in an example.
- ☐ Show the gains from specialization and trade in an example.
- ☐ Define the main characteristics of the foreign exchange market.
- ☐ Distinguish between the appreciation and depreciation of a currency.
- ☐ Identify four means by which governments interfere with free trade.
- ☐ Discuss two reasons why governments intervene in international trade.
- ☐ Give estimates of the cost to society from trade restrictions.
- ☐ List the major features of the Reciprocal Trade Agreements Act.
- ☐ State the three principles of the General Agreement on Tariffs and Trade (GATT).
- ☐ Identify the major provisions of the Uruguay round of GATT.
- ☐ Describe the World Trade Organization (WTO).
- ☐ Describe the history of and results from the European Union (EU).
- ☐ Explain what the euro is and the results from using it.
- ☐ Describe the North American Free Trade Agreement (NAFTA).
- ☐ Describe the Trade Adjustment Assistance Act of 2002.
- ☐ Evaluate reasons for and outcomes from offshoring.
- ☐ Discuss the effects of global competition on U.S. firms, workers, and consumers.
- ☐ Evaluate the overall effectiveness of fair-trade approaches to economic development (Last Word).

#### ■ CHAPTER OUTLINE

1. Four main categories of **economic flows** link nations: goods and services flows, capital and labor flows, information and technology flows, and financial flows.
2. Trade is important and thus warrants special attention.
  - a. Although the relative importance of international trade to the United States is less than it is for other nations, it is still vital.
    - (1) Exports and imports are about 12–17% of GDP, and the United States is the largest trading nation in the world.
    - (2) The U.S. economy depends on international trade for vital raw materials and a variety of finished products.

(3) There are some patterns in U.S. trade: The United States has a trade deficit because its exports exceed its imports. About half of U.S. export and import trade is with industrially advanced nations, with Canada being the largest trade partner; overall imports exceed exports, but the trade deficits are greatest with China, Japan, and OPEC countries.

(4) International trade must be financed, and, in the case of the United States, large trade deficits have required the selling of business ownership (securities) to companies in other nations.

b. Factors facilitating trade since World War II include improvements in transportation and communications technology, and a general decline in tariffs.

c. There are many participants in international trade. The United States, the nations of the European Union, Japan, and China are the major players in international trade.

3. Specialization and international trade are advantageous because they increase the productivity of a nation's resources, increase total output, and increase incomes.

4. **Comparative advantage** explains the gains from trade and is directly related to opportunity cost. In essence, a nation has a comparative advantage in the production of a good when it can produce the good at a lower domestic opportunity cost than can a trading partner. A nation will specialize in the production of a product for which it is the low (opportunity) cost producer and trade for the other goods it wants.

a. Suppose the world is composed of only two nations (the United States and Mexico), each of which is capable of producing two different goods (avocados and soybeans). The production possibilities table for each nation assumes a constant opportunity cost, so a constant amount of one good must be given up to get more of another good. With different domestic opportunity cost ratios, each nation will have a comparative (cost) advantage in the production of one of the two goods.

b. The ratio at which one product is traded for another—the **terms of trade**—lies between the opportunity cost ratios of the two nations.

c. Each nation gains from this trade because specialization permits a greater total output from the same resources and a better allocation of the world's resources.

5. The **foreign exchange market** is where national currencies, such as the European euro, Japanese yen, and U.S. dollar, are traded for each other. The equilibrium prices for national currencies are called **exchange rates** and represent how much of each nation's currency can be exchanged for another nation's currency.

a. In the dollar-yen market, the dollar price of a yen would be on the vertical axis and the quantity of yen would be on the horizontal axis. The intersection of the up-sloping supply of yen curve and down-sloping demand for yen curve would determine the dollar price of a yen.

b. If U.S. demand for Japanese goods increased, then more yen will be needed to pay for the goods, and



so the demand for yen would increase. This change increases the dollar price of yen, which means there has been a **depreciation** of the U.S. dollar relative to the yen. Conversely, if Japanese demand for U.S. goods increased, then more dollars would be needed to pay for the goods, and the supply of yen would increase. This change will decrease the dollar price of yen, which means there has been an **appreciation** of the U.S. dollar relative to the yen.

6. Governments often restrict trade in several ways and that has consequences.

a. There are four ways by which governments restrict trade:

- (1) placing **protective tariffs** (excise taxes or duties) on imported goods to protect domestic producers;
- (2) setting **import quotas** to limit the quantity or value of goods that can be imported;
- (3) imposing **nontariff barriers** such as burdensome and costly licensing or regulatory requirements;
- (4) using **export subsidies** that are government payments to domestic producers of imported goods.

b. Governments intervene in trade for two basic reasons:

- (1) The gains from trade are misunderstood. Exports are thought to be good because they increase domestic employment and imports are thought to be bad because they reduce domestic employment. The gains from trade come from increased output resulting from specialization and exchange that require importing and exporting.
- (2) Trade may be good for a nation as a whole, but certain groups or industries can be adversely affected by imports and thus they seek political protection through trade restrictions.

c. Trade restrictions impose substantial costs. Domestic consumers pay higher prices for products for which trade restrictions are imposed and so do domestic firms that use such products or other imported commodities in their production.

7. International trade policies have changed over the years with the development of multilateral agreements and free-trade zones. They are used to counter the destructive aspects of trade wars that arise when nations imposed high tariffs. A classic example is the **Smoot-Hawley Tariff Act** of 1930 that caused other nations to impose equally high tariffs, caused a trade war, and reduced worldwide trade.

a. U.S. trade policy has been significantly affected by the **Reciprocal Trade Agreements Act** of 1934. Until 1934, the United States steadily increased tariff rates to protect private interest groups, but since the passage of the 1934 act, tariff rates have been substantially reduced. This act gave the president the authority to negotiate with foreign nations and included most-favored-nation status (now renamed **normal-trade-relation [NTR] status**).

b. The **General Agreement on Tariffs and Trade (GATT)** began in 1947. GATT provided equal treatment of all member nations and sought to reduce tariffs and eliminate import quotas by multilateral negotiations.

The Uruguay Round of GATT negotiations started in 1986 and was completed in 1993. The major provisions, which were phased in through 2005, reduced tariffs on products, cut restrictive rules applying to services, phased out quotas on textiles and apparel, and decreased subsidies for agriculture.

c. The **World Trade Organization (WTO)** was the successor to GATT. It oversees trade agreements and provides a forum for trade negotiations, the latest of which is the **Doha Round** that was launched in 2001 in Doha, Qatar. The WTO works to expand trade and reduce protectionism, but the outcomes can be controversial.

d. The **European Union (EU)** is an example of a regional free-trade zone or **trade bloc** among 27 European nations.

(1) The EU abolished tariffs among member nations and developed common policies on various economic issues, such as the tariffs on goods to and from non-member nations. The EU has produced freer trade and increased economies of scale for production in its member nations, but such a trading bloc creates trade frictions with nonmember nations like the United States.

(2) Some 15 of the EU nations share a common currency—the **euro**. The chief advantages of such a currency is that it reduces transactions costs for exchanging goods and services in Euro Zone nations and allows consumers and businesses to comparison shop.

e. In 1993, the **North American Free Trade Agreement (NAFTA)** created a free-trade zone or trade bloc covering the United States, Mexico, and Canada. Critics of this agreement feared job losses and the potential for abuse by other nations using Mexico as a base for production, but the dire outcomes have not occurred. There has been increased trade among Canada, Mexico, and the United States because of the agreement.

8. Although increased trade and trade liberalization raise total output and income, they also create controversies and calls for assistance.

a. The **Trade Adjustment Assistance Act** of 2002 provides support to qualified workers displaced by imports or plant relocations from international trade. It gives cash assistance, education and training benefits, subsidies for health care, and wage subsidies (for those aged 50 or older). Critics contend that such dislocations are part of a market economy and workers in the international sector should not get special subsidies for their job losses.

b. Offshoring shifts work done in the United States to workers and locations in other nations. While it has long been used in manufacturing, improvement in communication and technology make it possible to do it in services. Offshoring, imports, and plant closings account for only about 3 percent of U.S. job losses, but these losses from international trade are often offset by gains in productivity and growth of other jobs.



9. Increased international trade has resulted in more global competition. Most U.S. firms have been able to meet the competitive challenge by lowering production costs, improving products, or using new technology. Some firms and industries have had difficulty remaining competitive and continue to lose market share and employment. Overall, increased trade has produced substantial benefits for U.S. consumers (lower prices and more products) and enabled the nation to make more efficient use of its scarce resources.

10. (Last Word). Fair-trade policies advocated by consumer organizations in the high-income nations seek to pay producers in low-income nations a higher-than-market price for certain products (such as coffee or cocoa). In return, the producers agree to pay their workers a higher-than-market wage. Such policies may help workers and producers in particular industries, but overall they are ineffective as a means for economic development because they simply shift and distort product and labor demand.

#### ■ HINTS AND TIPS

1. When the production possibilities schedules for two nations that trade two products have constant cost ratios, you can reduce the schedules to a  $2 \times 2$  table. Put the two products in the two columns and the two nations in the two rows of the matrix. In each cell of the matrix put the *maximum* of each product that can be produced by that row's nation. Then for each nation, divide the maximum of one product into the maximum amount of the other product to get the domestic opportunity cost of one product in terms of the other.

This point can be illustrated with an example from problem 2 in this study guide chapter. Lilliput can produce a *maximum* of 40 pounds of apples or 20 pounds of bananas. Brobdingnag can produce a *maximum* of 75 pounds of apples or 25 pounds of bananas. The  $2 \times 2$  matrix would look like this:

	Apples	Bananas
Lilliput	40	20
Brobdingnag	75	25

For Lilliput, the domestic opportunity cost of producing 1 pound of apples is .5 pound of bananas. In Brobdingnag, the domestic opportunity cost of producing 1 pound of apples is .33 pound of bananas. Brobdingnag is the lower (opportunity) cost producer of apples and will specialize in the production of that product. Lilliput is the lower (opportunity) cost producer of bananas, because producing 1 pound of bananas requires giving up 2 pounds of apples, whereas in Brobdingnag producing 1 pound of bananas requires giving up 3 pounds of apples.

2. Foreign exchange rates often confuse students because they can be expressed in two ways: the U.S. dollar price of a unit of foreign currency (\$1.56 for 1 British pound), or the amount of foreign currency that can be purchased by one U.S. dollar (\$1 can purchase .64 British pound). If you know the exchange rate in one way, you

can easily calculate it the other way. Using the information from the first way, dividing \$1.56 into 1 British pound gives you the British pound price for 1 U.S. dollar ( $1/1.56 = .64$  of a British pound). Using information from the second way, dividing .64 of a British pound into 1 U.S. dollar gives you the dollar price of a British pound ( $1/.64 = 1.56$ ). Both ways may be used, although one way may be used more often than the other. Rates for British pounds or Canadian dollars are usually expressed the first way, in terms of U.S. dollars. Rates for the Swiss franc, Japanese yen, or European euro are expressed the second way, per U.S. dollar.

#### ■ IMPORTANT TERMS

comparative advantage	normal-trade-relation status
terms of trade	General Agreement on Tariffs and Trade (GATT)
foreign exchange market	World Trade Organization (WTO)
exchange rates	Doha Round
depreciation	European Union (EU)
appreciation	trade bloc
protective tariffs	euro
import quotas	North American Free Trade Agreement (NAFTA)
nontariff barriers	Trade Adjustment Assistance Act
export subsidies	offshoring
Smoot-Hawley Tariff Act	
Reciprocal Trade Agreements Act	

#### SELF-TEST

#### ■ FILL-IN QUESTIONS

1. List the four major economic flows among nations.

- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_

2. The importance of international trade varies by nation. Nations in which exports account for a relatively high percentage of GDP tend to have a (limited, diversified)

\_\_\_\_\_ resource base and domestic market, whereas nations in which exports account for a lower percentage of GDP tend to have a \_\_\_\_\_ resource base and domestic market. An example of a higher exporting nation would be the (United States, Netherlands)

\_\_\_\_\_, and a lower exporting nation would be the \_\_\_\_\_.

3. In relative terms, the imports and exports of the United States amounted to about (12–17, 31–36) \_\_\_\_\_ %



of the economy's GDP in 2007. In absolute terms, the United States is the world's (smallest, largest) \_\_\_\_\_ trading nation. The largest trading partner for the United States is (Canada, Japan) \_\_\_\_\_. The United States has a large trade deficit with (Mexico, China) \_\_\_\_\_.

4. Factors that have helped increase the growth of world trade since World War II include improvement in \_\_\_\_\_ and \_\_\_\_\_ technology and a general decline in \_\_\_\_\_.

5. Specialization and trade (increase, decrease) \_\_\_\_\_ the productivity of a nation's resources and \_\_\_\_\_ total output more than would be the case without it.

6. When one nation has a lower opportunity cost of producing a product relative to another nation it has a (nontariff barrier, comparative advantage) \_\_\_\_\_. The amount of one product that must be given up to obtain 1 unit of another product is the (foreign exchange, opportunity cost) \_\_\_\_\_.

7. When the dollar price of foreign currency increases, there has been a(n) (appreciation, depreciation) \_\_\_\_\_ in value of the dollar. When the dollar price of foreign currency decreases, there has been a(n) \_\_\_\_\_ in the value of the dollar. For example, if the dollar price of a euro decreases from \$1.00 = 1 euro to \$0.90 = 1 euro, then it means that there has been a(n) (appreciation, depreciation) \_\_\_\_\_ in the value of the dollar; but if the dollar price of a euro increases from \$0.95 = 1 euro to \$1.05 = 1 euro, then it means that there has been a(n) \_\_\_\_\_ in the value of the dollar.

8. In the market for Japanese yen, an increase in the (demand for, supply of) \_\_\_\_\_ yen will decrease the dollar price of yen, while an increase in the \_\_\_\_\_ yen will increase the dollar price of yen. If the dollar price of the yen increases, then Japanese goods imported into the United States will be (more, less) \_\_\_\_\_ expensive.

9. The major government policies that restrict trade include

- excise taxes or duties on imported goods that are called \_\_\_\_\_.
- limits on the quantities or total value of specific items that may be imported, referred to as \_\_\_\_\_.
- licensing requirements, unreasonable standards, and hurdles and delays in customs procedures related to a product, which are \_\_\_\_\_.
- government payments to domestic producers of export goods, known as \_\_\_\_\_.

10. Governments may intervene in trade between nations because they mistakenly think of (exports, imports) \_\_\_\_\_ as helpful and \_\_\_\_\_ as harmful for a national economy. In fact, there are important gains from trade in the form of the extra output obtained from abroad. Trade makes it possible to obtain (exports, imports) \_\_\_\_\_ at a lower cost than would be the case if they were produced using domestic resources, and the earnings from \_\_\_\_\_ help a nation pay for these lower cost (exports, imports) \_\_\_\_\_.

11. Another reason governments interfere with free trade is (private, political) \_\_\_\_\_ considerations. Groups and industries seek protection from foreign competition through (GATT, tariffs) \_\_\_\_\_ and import (quotas, subsidies) \_\_\_\_\_, or other kinds of trade restrictions. The costs of trade protectionism are (clear to, hidden from) \_\_\_\_\_ consumers in the protected product so there is little opposition to demands for protectionism.

12. Tariffs and quotas (benefit, cost) \_\_\_\_\_ domestic firms in the protected industries, but \_\_\_\_\_ domestic consumers in the form of (lower, higher) \_\_\_\_\_ prices than would be the case if there were free trade. They also (benefit, cost) \_\_\_\_\_ domestic firms that use the protected goods as inputs in their production processes.

13. Until 1934, the trend of tariff rates in the United States was (upward, downward) \_\_\_\_\_. The trend has been (upward, downward) \_\_\_\_\_ since the 1934 passage of the (Smoot-Hawley Tariff, Reciprocal Trade Agreements) \_\_\_\_\_ Act. This act empowered the President to lower (tariffs, quotas) \_\_\_\_\_ by up to 50% in return for a reduction in foreign restrictions on U.S. goods. It incorporated most-favored-nation status into U.S. trade agreements for the first time. This status is now so common that it has been renamed (free-trade zone, normal-trade-relations) \_\_\_\_\_ status.

14. The three cardinal principles established in the General Agreement on Tariffs and Trade (GATT) of 1947 were

- \_\_\_\_\_.
- \_\_\_\_\_.
- \_\_\_\_\_.

15. GATT negotiations were conducted as (circles, rounds) "\_\_\_\_\_ " that last many years. One of the major provisions of the eighth round (the Uruguay Round) was to create a successor to GATT that is called the (Reciprocal, World) \_\_\_\_\_ Trade Organization. The current ninth round of negotiations is the (Abba,



Doha) \_\_\_\_\_ Round and it continues to focus on (increasing, reducing) \_\_\_\_\_ tariffs and quotas and \_\_\_\_\_ agricultural subsidies.

16. An example of a free-trade zone or trade bloc is the (Western, European) \_\_\_\_\_ Union.

a. The specific aims of the EU were the abolition of (capital and labor, tariffs and quotas) \_\_\_\_\_, the establishment of (common, different) \_\_\_\_\_ tariffs on goods imported from outside the EU, the (restricted, free) \_\_\_\_\_ movement of capital and labor within the EU, and common policies on other matters.

b. The EU created (small, large) \_\_\_\_\_ markets and stimulated production that has allowed industries to achieve (higher, lower) \_\_\_\_\_ costs. The economic effects of the EU on nonmember nations such as the United States are mixed because economic growth in the EU causes U.S. exports to the EU to (decrease, increase) \_\_\_\_\_ while the

tariff barriers cause U.S. exports to \_\_\_\_\_.  
c. The common currency of many of the member nations of the EU is called the (peso, euro) \_\_\_\_\_.

17. The North American Free Trade Agreement (NAFTA) formed a trade (barrier, bloc) \_\_\_\_\_ among the United States, Canada, and Mexico. This agreement will eliminate (terms of trade, tariffs) \_\_\_\_\_ among the nations. Critics in the United States said that it would (increase, decrease) \_\_\_\_\_ jobs, but the evidence shows a(n) \_\_\_\_\_ in jobs and total output since its passage.

18. The Trade Adjustment Assistance Act of 2002 is designed to help some of the (workers, businesses) \_\_\_\_\_ hurt by shifts in international trade patterns. Critics contend that such job losses are a (small, large) \_\_\_\_\_ fraction of the total each year and that such a program is another type of special (tariff, subsidy) \_\_\_\_\_ that benefits one type worker over another.

19. The shifting of work previously done by U.S. workers to workers located in other nations is (dumping, offshoring) \_\_\_\_\_. It reflects a (growth, decline) \_\_\_\_\_ in the specialization and international trade of services. It may (decrease, increase) \_\_\_\_\_ some jobs moved to other nations, but also \_\_\_\_\_ jobs and productivity in the United States.

20. Many U.S. firms can (monopolize, compete) \_\_\_\_\_ and be successful in the global economy; however, some firms that benefited from past trade protection may find it difficult to adjust to global (control, competition) \_\_\_\_\_ and may go out of business.

## TRUE-FALSE QUESTIONS

Circle T if the statement is true, F if it is false.

1. The United States exports and imports goods and services with a dollar value greater than any other nation in the world. T F

2. The United States is dependent on trade for certain commodities that cannot be obtained in domestic markets. T F

3. Canada is the most important trading partner for the United States in terms of the volume of exports and imports. T F

4. If a person, firm, or region has a comparative advantage in the production of a particular commodity, it should specialize in the production of that commodity. T F

5. If one nation has a comparative advantage in the production of a commodity over another nation, then it has a higher opportunity cost of production relative to the other nation. T F

6. The economic effects of specialization and trade between nations are similar to increasing the quantity of resources or to achieving technological progress. T F

7. The interaction of the demand for, and supply of, Japanese yen will establish the dollar price of Japanese yen. T F

8. An increase in incomes in the United States would tend to cause the dollar price of the Japanese yen to fall. T F

9. When the dollar price of another nation's currency increases, there has been an appreciation in the value of the dollar. T F

10. When the dollar depreciates relative to the value of the currencies of the trading partners of the United States, then goods imported into the United States will tend to become more expensive. T F

11. Export subsidies are government payments to reduce the price of a product to buyers from other nations. T F

12. Nontariff barriers include excise taxes or duties placed on imported goods. T F

13. Through world trade, an economy can reach a point beyond its domestic production possibilities curve. T F

14. One reason that trade restrictions get public support is that the alleged benefits of the restrictions are often immediate and clear-cut, but the adverse effects are often obscure and dispersed over the economy. T F

15. Tariffs and quotas benefit domestic firms in the protected industries and also help domestic consumers by lowering the prices for those products. T F

16. The Smoot-Hawley Tariff Act of 1930 reduced tariffs in the United States to the lowest level ever in an attempt to pull the nation out of the Great Depression. T F



17. If the United States concludes a tariff agreement that lowers the tariff rates on goods imported from another nation, the lower tariff rates are then applied to those goods when they are imported from nations with normal-trade-relation (NTR) status. T F

18. The World Trade Organization (WTO) is the world's major advocate for trade protectionism. T F

19. The members of the European Union (EU) have experienced freer trade since it was formed. T F

20. The economic integration of nations creates larger markets for firms within the nations that integrate and makes it possible for these firms and their customers to benefit from the economies of large-scale (mass) production. T F

21. The formation of the European Union (EU) may make it more difficult for U.S. firms to compete for European customers with firms located within the Union. T F

22. The 1993 North American Free Trade Agreement (NAFTA) includes all Central American nations. T F

23. The Trade Adjustment Assistance Act of 2002 provided compensation to U.S. workers who were displaced by shifts in international trade patterns. T F

24. Although offshoring decreases some U.S. jobs, it also lowers production costs, expands sales, and may create other U.S. jobs. T F

25. Major U.S. firms are unable to compete in global markets without significant protection from foreign competition. T F

#### MULTIPLE-CHOICE QUESTIONS

Circle the letter that corresponds to the best answer.

1. Which is a major economic flow that links the U.S. economy with the economies of other nations?

- (a) tariff flow
- (b) seasonal flow
- (c) financial flow
- (d) government flow

2. Which of the following is true?

- (a) Exports as a percentage of GDP are greatest in the United States.
- (b) The United States is almost totally dependent on other nations for aircraft, machine tools, and coal.
- (c) About half of the exports and imports trade of the United States is with industrially advanced nations.
- (d) The United States has a trade surplus with Japan.

3. A trade deficit occurs when

- (a) exports exceed imports
- (b) imports exceed exports
- (c) tariff costs exceed tariff benefits
- (d) tariff benefits exceed tariff costs

4. What is one way the United States finances its trade deficit?

- (a) by lending to foreigners
- (b) by selling real assets to foreigners
- (c) by purchasing real assets from foreigners
- (d) by passing protective tariffs on foreign products

5. Which factor has greatly facilitated international trade since World War II?

- (a) greater import quotas
- (b) expanded export subsidies
- (c) increased nontariff barriers
- (d) improved communications

6. Which industrializing nation would be considered one of the new participants in international trade since 1990?

- (a) Canada
- (b) Germany
- (c) Japan
- (d) China

7. Why do nations specialize and engage in trade?

- (a) to increase output and income
- (b) to improve communications
- (c) to protect corporations
- (d) to control other nations

Answer Questions 8, 9, 10, and 11 on the basis of the data given for two regions, Slobovia and Utopia, which have the following production possibilities tables.

SLOBOVIA PRODUCTION POSSIBILITIES TABLE

Product	Production alternatives					
	A	B	C	D	E	F
Cams	1500	1200	900	600	300	0
Widgets	0	100	200	300	400	500

UTOPIA PRODUCTION POSSIBILITIES TABLE

Product	Production alternatives				
	A	B	C	D	E
Cams	4000	3000	2000	1000	0
Widgets	0	200	400	600	800

8. In Slobovia, the comparative cost of

- (a) 1 cam is 3 widgets
- (b) 1 widget is .33 of a cam
- (c) 1 cam is .33 of a widget
- (d) 3 widgets is 1 cam

9. Which of the following statements is *not* true?

- (a) Slobovia should specialize in the production of widgets.
- (b) Slobovia has a comparative advantage in the production of widgets.
- (c) Utopia should specialize in the production of widgets.
- (d) Utopia has a comparative advantage in the production of cams.



10. The terms of trade will be
  - (a) greater than 7 cams for 1 widget
  - (b) between 7 cams for 1 widget and 5 cams for 1 widget
  - (c) between 5 cams for 1 widget and 3 cams for 1 widget
  - (d) less than 3 cams for 1 widget
11. Assume that if Slobovia did not specialize it would produce alternative C and that if Utopia did not specialize it would select alternative B. The gains from specialization are
  - (a) 100 cams and 100 widgets
  - (b) 200 cams and 200 widgets
  - (c) 400 cams and 500 widgets
  - (d) 500 cams and 400 widgets
12. If the dollar-yen exchange rate is \$1 for 110 yen, then a Sony VCR priced at 27,500 yen would cost a U.S. consumer
  - (a) \$200
  - (b) \$250
  - (c) \$275
  - (d) \$300
13. If the equilibrium exchange rate changes so that the dollar price of Japanese yen increases
  - (a) the dollar has appreciated in value
  - (b) the dollar has depreciated in value
  - (c) U.S. citizens will be able to buy more Japanese goods
  - (d) Japanese citizens will be able to buy fewer U.S. goods
14. A decrease in the United States demand for Japanese goods will
  - (a) increase the demand for Japanese yen and increase the dollar price of yen
  - (b) increase the demand for Japanese yen but decrease the dollar price of yen
  - (c) decrease the demand for Japanese yen and decrease the dollar price of yen
  - (d) decrease the demand for Japanese yen but increase the dollar price of yen
15. If the exchange rate for one U.S. dollar changes from 1.0 euro to 1.1 euros, then there has been
  - (a) an appreciation in the value of the euro
  - (b) a depreciation in the value of the dollar
  - (c) a depreciation in the value of the euro
  - (d) an increase in the price of the euro
16. Which of the following is designed to restrict trade?
  - (a) GATT
  - (b) NAFTA
  - (c) import quotas
  - (d) normal-trade-relations status
17. Why do governments often intervene to restrict international trade?
  - (a) to expand a nation's production possibilities
  - (b) to improve the position of global businesses
  - (c) to protect domestic industries from foreign competition
  - (d) to increase revenue from tariff duties and excise taxes
18. Tariffs and quotas in a nation benefit domestic
  - (a) consumers and foreign producers of the protected product
  - (b) consumers and producers of the protected product
  - (c) producers of the protected product, but harm domestic consumers of the product
  - (d) producers and foreign producers of the product
19. Which one of the following specifically empowered the president of the United States to reduce tariff rates up to 50% if other nations would reduce their tariffs on American goods?
  - (a) the Smoot-Hawley Tariff Act of 1930
  - (b) the Reciprocal Trade Agreements Act of 1934
  - (c) the General Agreement on Tariffs and Trade of 1947
  - (d) North American Free Trade Agreement of 1993
20. Which of the following is characteristic of the General Agreement on Tariffs and Trade? Nations signing the agreement were committed to
  - (a) the expansion of import quotas
  - (b) the establishment of a world customs union
  - (c) the reciprocal increase in tariffs by negotiation
  - (d) the nondiscriminatory treatment of all member nations
21. One important outcome from the Uruguay Round of GATT was
  - (a) an increase in tariff barriers on services
  - (b) establishment of the World Trade Organization
  - (c) removal of voluntary export restraints in manufacturing
  - (d) abolishment of patent, copyright, and trademark protection
22. One of the potential problems with the European Union is that
  - (a) an unregulated free flow of labor and capital may reduce productivity
  - (b) economies of large-scale production may increase consumer prices
  - (c) tariffs may reduce trade with nonmember nations
  - (d) governments may have difficulty covering the shortfall from the elimination of duties and taxes
23. An example of the formation of a trade bloc would be the
  - (a) Smoot-Hawley Tariff Act
  - (b) North American Free Trade Agreement
  - (c) Reciprocal Trade Agreements Act
  - (d) General Agreement on Tariffs and Trade
24. The Trade Adjustment Assistance Act
  - (a) increased funding for the World Trade Organization
  - (b) provided more foreign aid to nations that trade with the United States
  - (c) extended normal-trade-relations status to more less-developed countries
  - (d) gave cash assistance to U.S. workers displaced by imports or plant relocations abroad



25. The increase in global competition has resulted in
- greater inefficiency among U.S. producers
  - lower quality in the production of goods
  - the inability of most U.S. firms to compete
  - lower prices for many consumer goods and services

### PROBLEMS

1. The following problem will help you understand the principle of comparative advantage and the benefits of specialization. A tailor named Hart has the production possibilities table for trousers and jackets as given. He chooses production alternative D.

**HART'S PRODUCTION POSSIBILITIES TABLE**

Product	Production alternatives					
	A	B	C	D	E	F
Trousers	75	60	45	30	15	0
Jackets	0	10	20	30	40	50

Another tailor, Schaffner, has the following production possibilities table and produces production alternative E.

**SCHAFFNER'S PRODUCTION POSSIBILITIES TABLE**

Product	Production alternatives						
	A	B	C	D	E	F	G
Trousers	60	50	40	30	20	10	0
Jackets	0	5	10	15	20	25	30

a. To Hart,

(1) the cost of one pair of trousers is \_\_\_\_\_ jackets

(2) the cost of one jacket is \_\_\_\_\_ pairs of trousers

b. To Schaffner,

(1) the cost of one pair of trousers is \_\_\_\_\_ jackets

(2) the cost of one jacket is \_\_\_\_\_ pairs of trousers

c. If Hart and Schaffner were to form a partnership to make suits,

(1) \_\_\_\_\_ should specialize in the making of trousers because he can make a pair of trousers at the cost of \_\_\_\_\_ of a jacket while it costs his partner \_\_\_\_\_ of a jacket to make a pair of trousers.

(2) \_\_\_\_\_ should specialize in the making of jackets because he can make a jacket at the cost of \_\_\_\_\_ pairs of trousers while it costs his partner \_\_\_\_\_ pairs of trousers to make a jacket.

d. Without specialization, Hart and Schaffner were able to make 50 pairs of trousers and 50 jackets. If each specializes completely in the item in the production in which he has a comparative advantage, their combined production will be \_\_\_\_\_ pairs of trousers and \_\_\_\_\_ jackets. Thus the gain from specialization is \_\_\_\_\_.

e. When Hart and Schaffner come to divide the income of the partnership between them, the manufacture of a pair of trousers should be treated as the equivalent of from \_\_\_\_\_ to \_\_\_\_\_ jackets (or a jacket should be treated as the equivalent of from \_\_\_\_\_ to \_\_\_\_\_ pairs of trousers).

2. The countries of Lilliput and Brobdingnag have the production possibilities tables for apples and bananas shown below.

Note that the costs of producing apples and bananas are constant in both countries.

**LILLIPUT PRODUCTION POSSIBILITIES TABLE**

Product	Production alternatives					
	A	B	C	D	E	F
Apples	40	32	24	16	8	0
Bananas	0	4	8	12	16	20

**BROBDINGNAG PRODUCTION POSSIBILITIES TABLE**

Product	Production alternatives					
	A	B	C	D	E	F
Apples	75	60	45	30	15	0
Bananas	0	5	10	15	20	25

a. In Lilliput the cost of producing

(1) 8 apples is \_\_\_\_\_ bananas

(2) 1 apple is \_\_\_\_\_ bananas

b. In Brobdingnag the cost of producing

(1) 15 apples is \_\_\_\_\_ bananas

(2) 1 apple is \_\_\_\_\_ bananas

c. In Lilliput the cost of producing

(1) 4 bananas is \_\_\_\_\_ apples

(2) 1 banana is \_\_\_\_\_ apples

d. In Brobdingnag the cost of producing

(1) 5 bananas is \_\_\_\_\_ apples

(2) 1 banana is \_\_\_\_\_ apples

e. The cost of producing 1 apple is lower in the country of \_\_\_\_\_ and the cost of producing 1 banana is lower in the country of \_\_\_\_\_.

f. Lilliput has a comparative advantage in the production of \_\_\_\_\_ and Brobdingnag has a comparative advantage in the production of \_\_\_\_\_.

g. The information in this problem is not sufficient to determine the exact terms of trade, but the terms of trade will be greater than \_\_\_\_\_ apples for 1 banana and less than \_\_\_\_\_ apples for 1 banana. Put another way, the terms of trade will be between \_\_\_\_\_ bananas for 1 apple and \_\_\_\_\_ bananas for 1 apple.



h. If neither nation could specialize, each would produce production alternative C. The combined production of apples in the two countries would be \_\_\_\_\_ apples and the combined production of bananas would be \_\_\_\_\_ bananas.

(1) If each nation specializes in producing the fruit for which it has a comparative advantage, their combined production will be \_\_\_\_\_ apples and \_\_\_\_\_ bananas.

(2) Their gain from specialization will be \_\_\_\_\_ apples and \_\_\_\_\_ bananas.

3. Use the following table that shows 10 different currencies and how much of each currency can be purchased with a U.S. dollar.

Country	Currency	Currency per U.S. \$		A or D
		Year 1	Year 2	
Brazil	Real	0.85	0.91	_____
Britain	Pound	0.65	0.59	_____
Canada	Dollar	1.41	1.51	_____
Switzerland	Franc	1.33	1.19	_____
Germany	Euro	1.58	1.69	_____
India	Rupee	31.39	34.55	_____
Japan	Yen	100.15	110.23	_____
Mexico	Peso	4.65	5.09	_____
Norway	Krone	6.88	6.49	_____
Thailand	Bhat	25.12	23.22	_____

a. In the far right column of the table, indicate whether the U.S. dollar has appreciated (A) or depreciated (D) from year 1 to year 2.

b. In year 1, a U.S. dollar would purchase \_\_\_\_\_ Swiss francs, but in year 2, it would purchase \_\_\_\_\_ Swiss francs. The U.S. dollar has (appreciated, depreciated) \_\_\_\_\_ against the Swiss franc from year 1 to year 2.

c. In year 1, a U.S. dollar would purchase \_\_\_\_\_ Japanese yen, but in year 2, it would purchase \_\_\_\_\_ Japanese yen. The U.S. dollar has (appreciated, depreciated) \_\_\_\_\_ against the Japanese yen from year 1 to year 2.

4. This problem asks you to calculate prices based on exchange rates. Use the data in the table for Problem 3 to answer the following items.

a. Using the exchange rates shown for year 1, what would be the U.S. dollar cost for the following products?

(1) Japanese television costing 30,000 yen.

\$ \_\_\_\_\_

(2) Swiss scarf costing 200 francs.

\$ \_\_\_\_\_

(3) Thai artwork costing 3,768 bhat.

\$ \_\_\_\_\_

(4) German auto costing 79,000 euros.

\$ \_\_\_\_\_

(5) Mexican silver bracelet costing 1,376 pesos.

\$ \_\_\_\_\_

b. Using the exchange rates shown for year 2, what would be the U.S. dollar cost of the following products?

(1) Japanese television costing 30,000 yen.

\$ \_\_\_\_\_

(2) Swiss scarf costing 200 francs.

\$ \_\_\_\_\_

(3) Thai artwork costing 3,768 bhat.

\$ \_\_\_\_\_

(4) German auto costing 79,000 euros.

\$ \_\_\_\_\_

(5) Mexican silver bracelet costing 1,376 pesos.

\$ \_\_\_\_\_

c. Indicate whether the U.S. dollar cost of each product in 4b has increased (+) or decreased (–) from year 1 to year 2 \_\_\_\_\_

d. What is the relationship between your answers in 4c to the ones you gave for the corresponding nations in 3a?

(1) When the U.S. dollar *appreciates* in value against a foreign currency, the U.S. dollar cost of a product from that nation will (increase, decrease) \_\_\_\_\_

(2) When the U.S. dollar *depreciates* in value against a foreign currency, the U.S. dollar cost of a product from that nation will (increase, decrease) \_\_\_\_\_

#### ■ SHORT ANSWER AND ESSAY QUESTIONS

1. Describe the four major economic flows that link the United States to other nations.

2. What are the principal exports and imports of the U.S. economy? What commodities used in the economy come almost entirely from abroad, and what American industries sell large percentages of their outputs abroad?

3. What is meant by comparative cost and comparative advantage? Explain how comparative advantage determines the terms of trade between nations.

4. What is the gain for a nation that results from specialization in the production of products for which there is a comparative advantage?

5. Describe the characteristics of a foreign exchange market and of exchange rates. Why is an exchange rate an unusual price?

6. Why might an appreciation of the value of the U.S. dollar relative to the Japanese yen depress the U.S. economy and stimulate the Japanese economy? Why might a government intervene in the foreign exchange market and try to increase or decrease the value of its currency?

7. What are the major trade impediments and subsidies? How do they restrict international trade?

8. Why do governments intervene in international trade and develop restrictive trade policies?

9. What is the cost to society from trade protectionism? Who benefits and who is hurt by trade protectionism?

10. What was the Smoot-Hawley Tariff Act of 1930? What international trade problems are illustrated by this act?

11. Explain the basic provisions of the Reciprocal Trade Agreements Act of 1934.



12. What were the cardinal principles contained in the General Agreement on Tariffs and Trade (GATT)? What were the basic provisions and important results of the Uruguay Round of GATT negotiations?

13. Describe the purpose of the World Trade Organization (WTO). Why is it controversial?

14. What is the European Union? What has it achieved?

15. Discuss the potential effects of the European Union on the trade of the United States.

16. What is the euro and what have been its likely economic effects?

17. What is the North American Free Trade Agreement (NAFTA)? What do critics and defenders say about the agreement?

18. Discuss the purpose of the Trade Adjustment Assistance Act of 2002 and its advantages and disadvantages.

19. Explain the reasons U.S. businesses have turned to offshoring and evaluate the costs and benefits of such actions.

20. Evaluate the effects of increased global competition on U.S. firms, workers, and consumers.

16. European; a. tariffs and quotas, common, free; b. large, lower, increase, decrease; c. euro  
17. bloc, tariffs, decrease, increase  
18. workers, small, subsidy  
19. offshoring, growth, decrease, increase  
20. compete, competition

#### TRUE-FALSE QUESTIONS

- |                  |                    |                    |
|------------------|--------------------|--------------------|
| 1. T, p. 93      | 10. T, p. 100      | 19. T, p. 104      |
| 2. T, p. 93      | 11. T, p. 101      | 20. T, p. 104      |
| 3. T, pp. 94-95  | 12. F, p. 101      | 21. T, p. 104      |
| 4. T, pp. 96-98  | 13. T, p. 99       | 22. F, p. 105      |
| 5. F, pp. 96-98  | 14. T, pp. 101-102 | 23. T, pp. 105-106 |
| 6. T, pp. 98-99  | 15. F, p. 102      | 24. T, pp. 106-107 |
| 7. T, pp. 99-100 | 16. F, p. 102      | 25. F, p. 108      |
| 8. F, p. 100     | 17. T, pp. 102-103 |                    |
| 9. F, p. 100     | 18. F, pp. 103-104 |                    |

#### MULTIPLE-CHOICE QUESTIONS

- |                 |                    |                    |
|-----------------|--------------------|--------------------|
| 1. c, p. 92     | 10. c, p. 98       | 19. b, pp. 102-103 |
| 2. c, pp. 93-95 | 11. a, pp. 98-99   | 20. d, p. 103      |
| 3. b, p. 94     | 12. b, pp. 99-100  | 21. b, p. 103      |
| 4. b, p. 95     | 13. b, p. 100      | 22. c, p. 104      |
| 5. d, p. 95     | 14. c, p. 100      | 23. b, p. 105      |
| 6. d, p. 96     | 15. c, p. 100      | 24. d, pp. 105-106 |
| 7. a, p. 96     | 16. c, p. 101      | 25. d, p. 108      |
| 8. c, pp. 96-98 | 17. c, pp. 101-102 |                    |
| 9. c, pp. 96-98 | 18. c, p. 102      |                    |

#### ANSWERS

##### Chapter 5 The United States in the Global Economy

#### FILL-IN QUESTIONS

- a. goods and services flows (trade flows); b. capital and labor flows (resource flows); c. information and technology flows; d. financial flows (any order for a-d)
- limited, diversified; Netherlands, United States
- 12-17, largest, Canada, China
- transportation, communications (any order), tariffs
- increase, increase
- comparative advantage, opportunity cost
- depreciation, appreciation, appreciation, depreciation
- supply of, demand for, more
- a. protective tariffs; b. import quotas; c. nontariff barriers; d. export subsidies
- exports, imports, imports, exports, imports
- political, tariffs, quotas, hidden from
- benefit, cost, higher, cost
- upward, downward, Reciprocal Trade Agreements, tariffs, normal-trade relations
- a. equal, nondiscriminatory treatment of all member nations; b. reduction of tariffs by multilateral negotiations; c. elimination of import quotas
- rounds, World, Doha, reducing, reducing

#### PROBLEMS

- a. (1) .67, (2) 1.5; b. (1) .5, (2) 2; c. (1) Schaffner, .5, .67; (2) Hart, 1.5, 2; d. 60, 50, 10 pairs of trousers; e. .5, .67, 1.5, 2
- a. (1) 4, (2) .5; b. (1) 5, (2) .33; c. (1) 8, (2) 2; d. (1) 15, (2) 69, 18, (1) 75, 20, (2) 6, 2
- a. A, D, A, D, A, A, A, A, D, D; b. 1.33, 1.19, depreciated; c. 100.15, 110.23, appreciated
- a. (1) 299.55 (2) 150.38 (3) 150 (4) 50,000 (5) 295.91; b. (1) 272.16 (2) 168.07 (3) 162.27 (4) 46,745.56 (5) 270.33; c. (1) - (2) + (3) + (4) - (5) -; d. (1) decrease (2) increase

#### SHORT ANSWER AND ESSAY QUESTIONS

- |               |                 |                 |
|---------------|-----------------|-----------------|
| 1. p. 92      | 8. pp. 101-102  | 15. p. 104      |
| 2. pp. 92-95  | 9. p. 102       | 16. pp. 104-105 |
| 3. pp. 96-98  | 10. p. 102      | 17. p. 105      |
| 4. pp. 98-99  | 11. pp. 102-103 | 18. pp. 105-106 |
| 5. p. 99      | 12. p. 103      | 19. pp. 106-107 |
| 6. pp. 99-100 | 13. pp. 103-104 | 20. p. 108      |
| 7. p. 101     | 14. p. 104      |                 |